CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
Telephone: (916) 795-3400

August 14, 2006

AGENDA ITEM 7b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Corporate Governance Co-Investment Strategy

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information Item

IV. ANALYSIS:

<u>Executive Summary</u>

The Co-Investment Strategy in the Corporate Governance unit has performed well for the past three years. Staff is seeking input from the Investment Committee on expansion of the program. This agenda item sets forth a proposed framework for the program's expansion.

Wilshire Associates' opinion letter is Attachment 1.

Staff's proposed expansion of the Program includes:

- A new delegation of authority to the Senior Investment Officer – Global Equity.
- Amending the current Policy.
- Based on the input received, staff will return to the Committee in September with an action item.

<u>Background</u>

The success of Corporate Governance investing, including co-investment activity, has encouraged CalPERS' staff to seek an expansion of the co-investment strategy. As of March 31, 2006 the co-investment program had generated an annualized return of 30.77% versus the benchmark's 15.40% to provide value added of 15.37%. (Details are contained in Attachment 2.) These results derived from an extremely concentrated portfolio. Staff believes that providing for increased capacity and flexibility in the program shall allow for diversification benefits, the continuance of excellent historic results, facilitating an increase in the materiality of these results and improving the timeliness of activities.

Delegation of Authority

The new delegation of authority to the Senior Investment Officer – Global Equity contains these provisions:

- Delegation of authority to execute co-investment agreements with additional co-investment partners. (Criteria specified in proposed Policy changes below.)
- The maximum allocation of capital to each additional co-investment partners is $150 million. This capital allocation is in addition to the $500 million current limit on the program.
- There will be a maximum number of three co-investments with each additional co-investment partner.

Investment Committee approval of this delegation of authority would necessitate changes to the existing California Public Employees' Retirement System Statement of Investment Policy for Internal Relational Program (The Policy).

Policy Change

The needed modifications to implement staff's proposal affect several segments of the existing Policy including sections related to Investment Staff duties and Investment Approaches, Selection and Parameters. Existing investment parameters of The Policy include the following:

- Staff is responsible for presenting potential co-investment partners to the Investment Committee before executing an agreement with the partner.
- The Internal Relational Portfolio (the "Portfolio") is not to exceed $500 million on a cost basis without prior approval of the Investment Committee.
- Co-investment opportunities are limited to US (in partnership with Relational Investors LLC) and European (in partnership with Knight Vinke Asset Management) publicly traded equity securities.

Policy changes proposed by staff would modify some of the existing parameters and specify criteria for the selection of applicable external partners.

The most important changes would be:

- Adopt the following criteria for selecting additional co-investment partners:
  1. Serve as a CalPERS external corporate governance manager for at least one year.
  2. The corporate governance external manager's portfolio total return should exceed that for their specific benchmark since inception.

- Allow investments on a global basis recognizing any other CalPERS investment Policies that impact the universe of available public equity.
- Remove the requirement that potential partners be presented to the Investment Committee before executing an agreement with them.

Should the Investment Committee approve this initiative in the future, the matter will be taken to the Investment Policy Subcommittee for approval of the policy amendment.

Staff anticipates that addition resources, specifically a Portfolio Manager position, to implement the expanded program, as well as the ever expanding demands on all Corporate Governance staff. The new Portfolio Manager would be an experienced investment management professional and have responsibility for successfully managing the co-investment strategy, with the oversight of the Senior Portfolio Manager and the Senior Investment Officer.

V. STRATEGIC PLAN:

This item is consistent with Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX, achieve long term, sustainable risk adjusted returns. This item is part of the Global Equity 2005-2006 Annual Plan.

VI. RESULTS/COSTS:

The annual 15.37% value added since the program's November 2002 inception represents extraordinary results. Staff believes that the attractive historical performance warrants an expansion of the co-investment program. The challenge is to maintain these results while expanding the materiality through increasing the amount of capital deployed in the program.

Expanding the co-investment program is expected to generate costs due to the increased research workload. It is estimated that the Portfolio Manager level resource needed to support the growth of the co-investment program would create annual expenses of $150,000.

Dennis Johnson
Senior Portfolio Manager
Corporate Governance

Christianna Wood
Senior Investment Officer
Global Equity

Russell Read
Chief Investment Officer